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12th November 2010

Your reference: SEM-10-068

**CPM Medium Term Review
Work Package 7 – BNE Calculation Methodology**

Dear Sirs,

ESB Wind Development Ltd. (ESBWD) is pleased to submit its response to this consultation.

If you have any questions or would like to discuss any of the matters raised further please do not hesitate to contact me.

Yours sincerely,



Áine Dorrán

ESB Wind Development Ltd.

Introduction

The first section of the response deals with general comments. The second part gives responses to the specific topics discussed in the discussion paper.

Section 1: General Comments

Differentiation

In this paper the topic of differentiation between generators in their treatment within the Capacity Payment Mechanism (CPM) is discussed. We consider that the introduction of differentiation would be in direct conflict with the current CPM objective of fairness under which it is stated that the CPM “should not unfairly discriminate between participants”. Currently the rules of the CPM ensure that all generators are treated the same and receive the same payments when available at the same time. We consider that this is an important element of the scheme and should remain the case.

CPM Review Approach

The piecemeal approach to review and changes in the SEM is of on-going concern. Even within the CPM review it seems that there is crossover of topics within the Work Packages (WP). While this discussion paper was supposed to focus on the BNE calculation methodology, the issue of differentiation was also covered. It is unclear how all the WPs within the CPM review will be brought together. Will the remaining WPs be consulted on individually or together and will there be an overall discussion paper? It is also unclear where some key issues will be addressed within the WPs. For example, the criteria for selection of the BNE plant type, in the context that the majority of investment in new generation in the SEM over the next ten years will be in wind generation.

It is also unapparent as to how this review is linking in with other consultations, which are either on-going or promised. It would be useful to see the overall framework to which the RAs are working to with regard to market design review.

Renewable Generation & the CPM

We would like to highlight the important role that renewable generators play in meeting the three key objectives of the CPM as set out in SEM legislation:

- i. There have been numerous new renewable entrants into the SEM the impact of which can only be beneficial in terms of “*Competition and Consumers*”.
- ii. It has also been shown that the market price of electricity falls as the share of renewable generation grows, which is of clear benefit to consumers.

- iii. With regard to “*Security of Supply*” it is clear that an increase in renewable generation reduces the islands’ dependence on imported fossil fuels and provides self-sufficiency in terms of being able to meet demand through indigenous resources.
- iv. Finally, the “*Sustainability*” benefits of renewable generation are clear and powerful.

It is crucial that the contribution of renewable generation in terms of meeting these objectives is recognised.

Section 2: Responses to Specific Topics

2.1 International Experience

The review of the CPMs in other countries and markets was a useful exercise. We would be interested in receiving any more information and detail the RAs have on this. For example, how renewable generators are treated in all the capacity mechanisms reviewed.

2.2 BNE Calculation Methodology

The alternative option which is presented in the paper for the calculation of the BNE costs proposes a value for VOLL to be used in its methodology. The value attributed to VOLL then becomes of fundamental importance to the value assigned to the BNE and hence the value of the overall capacity pot. It is always going to be extremely difficult to estimate with any accuracy a value for VOLL and it will end up being to some part a subjective and arbitrary figure. Its derivation would not be clear or easily understood and would consequently be at odds with the CPM objective of simplicity which states that the CPM should be transparent.

The consultation paper suggests that in economic theory this methodology for the calculation of the BNE appears theoretically correct and simple in nature. However we consider that the subjectivity and lack of transparency associated with it mean that it should not be used in the CPM. The current approach is more easily understood, more robust and has the capacity to be more objective.

2.3 Stability Options

Stabilising the costs of the BNE can bring benefits in terms of the certainty it brings to investors with regard to the level of future payments. There is also a potential drawback to this approach in that the actual market costs associated with the BNE do vary year on year and so by fixing some elements of the cost in advance a disjoint may arise between real costs and those reflected in the CPM. However, we acknowledge

and accept that the market may need some measure of stability introduced into the BNE calculation.

The indexing options used should reflect as best as possible, the key items in the cost of a BNE which are most likely to change and whose change will have the most significant impact.

2.4 WACC

The WACC value selected each year is of crucial importance to the calculation of the BNE costs and hence the total capacity pot. The annual review of the WACC value is therefore essential and the current volatility in the investment markets highlights its importance. Gearing ratios and the costs of debt and equity can vary considerably year on year. In the current calculation methodology there is a high reliance on spot data and historic one-year averages. However, we consider that historical averages are not an adequate indication of future costs. The current volatility in the Irish markets, with higher costs of debt and equity evidenced since the 2011 WACC was set, highlights the dangers of the use of historical averages. Greater emphasis should be placed on current trends and forecasts, insofar as possible, in the formation of the WACC value.